Section 118 and the Tax Treatment of Nonshareholder Contributions to Capital

LAWRENCE A. FROLIK*

Not unlike Caeser's Gaul, all receipts of a corporation can be divided into three parts: gross income, capital contributions, and gifts. This article discusses the second type of receipts: capital contributions, or perhaps more accurately, corporate receipts that courts have classified as capital contributions. For more than fifty years capital contributions to a corporation by nonshareholders have been nontaxable to the recipient corporation. In the last few years shopping center developers have seized this device as a means of enhancing the attractiveness of their developments by making tax free contributions to the capital of their tenants. This novel use of an old doctrine has disturbing connotations that warrant reexamination of the nontaxability of nonshareholder capital contributions.

I. JUDICIAL AND LEGISLATIVE BACKGROUND

Gross income of corporations has always been taxable to the extent that it is not off-set by corresponding deductions.[1] Gifts, on the other hand, have always been excluded from taxable income.[2] Shareholder capital contributions to corporations have also always escaped taxation.[3] Congress has never seen fit to tax corporations upon receipt of cash or property in exchange for stock in the corporation, whether upon initial organization or upon post-organization increases in corporate capital. Nonshareholder contributions to the corporation, however, have travelled a more twisted road.

A. Cuba Railroad *and its Progeny*

Originally, the government's position was that, except on the rare occasion of a gift, all cash payments to a corporation by nonshare-

---

* Assistant Professor of Law, University of Pittsburgh School of Law.

1. The sixteenth amendment, which was adopted in 1913, gave Congress the power to "lay and collect taxes on incomes, from whatever source derived." The first internal revenue law enacted after that amendment made the gross income of a corporation taxable. Act of October 3, 1913, ch. 16, § II(G), 38 Stat. 172. This practice was continued in the Internal Revenue Code of 1939, ch. 1, § 13, 53 Stat. 7 and presently such treatment is accorded corporations in I.R.C. § 11.

2. After the adoption of the sixteenth amendment, the 63rd Congress, through the Act of October 3, 1913, ch. 16, § II(B), 38 Stat. 167 (1913), excluded gifts as items of taxable income. This practice was continued in the Internal Revenue Code of 1939, ch. 1, § 22(b)(3), 53 Stat. 10, and now by I.R.C. § 102.

3. I.R.C. § 118. Prior to the enactment in 1954 of § 118, common-law doctrines held that contributions to the capital of a corporation were not income to the recipient corporation.

holders were gross income to the corporation and thus properly includable in the corporation's taxable income.[4] In 1925 the Supreme Court in *Edwards v. Cuba Railroad*[5] rejected the government's contention that a capital contribution by a nonshareholder was taxable, thus holding in effect that nonshareholders, as well as shareholders, could make nontaxable contributions to a corporation.[6]

Cuba Railroad arose from the Cuban government's subsidization of private railroad construction in Cuba. To induce construction of the railroad the Cuban government agreed to reimburse Cuba Railroad in the form of both cash and property costs of construction. The Supreme Court held that the cash payments, reimbursement by the Cuban government for the capital costs of construction, were nontaxable additions to the Cuba Railroad's capital, concluding that the contributions were not income within the meaning of the sixteenth amendment.[7] Although the broad definition of income later advanced by the Supreme Court in *Commissioner v. Glenshaw Glass Co.*[8] would apparently allow nonshareholder capital contributions to be constitutionally classified as income under the sixteenth amendment, the influence of *Cuba Railroad* continues undiminished because the Court delineated the criteria that distinguish capital contributions from either income or gifts. In spite of being fifty years old, these criteria remain significant because they were the basic tests for identifying capital contributions throughout scores of cases and were finally codified in section 118 of the Internal Revenue Code. In fact, the Supreme Court did not attempt another inclusive test for distinguishing between capital contributions and income until 1973.[9]

The Court in *Cuba Railroad* relied on three criteria in determining whether the transfers were capital contributions. First, the Court noted that the Commissioner had not asserted taxability to the corporation of physical properties that the Cuban government had transferred to the corporation. The Court asserted without explanation that the Commissioner was correct in not taxing the transfer of the physical properties, saying only that the properties were "clearly" not taxable income.[10] Second, the Court found the payments directly proportional to the number of rail miles completed and on that basis concluded that the payments represented reimbursement for the capital cost of the rail lines regardless whether the payments were made prior to or after the construction of the rail lines.[11] Third, the Court

4. *See* Eisner v. Macomber, 252 U.S. 189 (1920).
5. 268 U.S. 628 (1925).
6. *Id.* at 632-33.
7. *Id.* at 633.
8. 348 U.S. 426 (1955).
9. United States v. Chicago, B & Q.R.R., 412 U.S. 401 (1973).
10. 268 U.S. at 632.
11. *Id.*

held the payments by the Cuban government were not gifts to the railroad. The Court pointed out that governmental subsidies to railroads had long been popular in the United States on the theory that the benefits accruing to the government or its citizenry justified the expense. Hence, because there was benefit to the contributor the donative intent necessary for a gift was lacking.[12] Finally, the Court held the subsidy payments were not made for services rendered or to be rendered to the Cuban government. Although the Cuban government received specific benefits from its contribution in the form of rate concessions, the Court thought the importance of these specific benefits did not outweigh the benefits that were expected to accrue to the general welfare of the Cuban population as well as the government of Cuba. Consequently, these contributions could not be considered payments for services.[13]

In short, the Court reasoned that: 1) whether the form of the subsidy is cash or physical goods is irrelevant, provided that: 2) the amount of the subsidy is directly proportional and traceable to capital items; and 3) the payment is not for services rendered or to be rendered; that is, the benefits to the contributor must be indirect or for a third party.

Although the Court's reasoning has been applied in one form or another for over fifty years, an important extension occurred only one year after *Cuba Railroad.* In *Liberty Light & Power Co.*[14] the Board of Tax Appeals held, under the principles of *Cuba Railroad*, that subsidies from a private party—as opposed to a governmental party—to a corporation were nontaxable contributions to capital. The Liberty Light & Power Company required rural consumers to pay for power line extensions as a precondition to supplying the customers with electricity. The board held the value of the completed lines, which were turned over to the power company, did not constitute income[15] but did not discuss the difference between a government, such as Cuba, and private, individual consumers in analyzing whether the payments actually represented payments for service. The board virtually ignored the third part of the *Cuba Railroad* test by failing to analyze whether the payments were made in consideration for service. The fact that the donated electric lines were clearly capital items in the hands of the power company seemed determinative to the board.[16]

After *Liberty Light*, the Commissioner of Internal Revenue repeatedly lost his attempts to tax contributions of cash or physical property by governmental units or consumers to railways, electrical

12. *Id.*

13. *Id.* at 632-33.

14. 4 B.T.A. 155 (1926), *acq.* VI-1 C.B. 4 (1927).

15. *Id.* at 164.

16. *Id.*

companies, and water companies.[17] Courts repeatedly applied the basic *Cuba Railroad* principle that items segregated for use as capital or payments made in direct proportion to capital expenditures by the corporation were to be treated as nontaxable capital contributions.

Examination of those cases, however, reveals a general failure by the courts to give sufficient weight to the third part of the *Cuba Railroad* test: whether the contribution was essentially payment for past or future services. Instead, the courts concentrated on the application of proceeds from the transfer. If the proceeds were traceable directly to capital contributions or were in the form of capital items such as electric lines or water lines, the courts would look no further. In short, the courts used what might be called an "application" test, which reduced the original three-part test of *Cuba Railroad* to a single litmus paper test of the application of proceeds.[18]

B. *The Supreme Court Takes a New Look:* Detroit Edison *and* Brown Shoe

In 1943 the Supreme Court made a complete turnabout from the pattern followed by the lower courts. In the case of *Detroit Edison Co. v. Commissioner*,[19] the Court ignored the first two tests of *Cuba Railroad* and looked solely to the third test: whether there had been payment for services rendered. The case contained facts not unlike the facts in *Liberty Light Co.* In both cases a power company required customers to pay for the necessary construction of electric lines to their homes, and the lines were then turned over to the power company. The Supreme Court held that customer payments to the power company for the cost of line construction to their homes were nothing more than part of the price of the service.[20] The issue before the Court was not whether the payments were income, but what was the basis of the power lines in the company's hands for depreciation purposes. Because the taxpayer utility had not reported the customer payments as income—presumably because of the decision in *Cuba Railroad*—the Court held the assets had a zero basis.[21] The Supreme Court recognized and eliminated the opportunity for a double tax benefit realized through: first, the receipt of nontaxable income; and, second, the depreciation of the cost of power lines purchased with that income.

17. Fairfax County Water Author. v. United States, 223 F. Supp. 620 (E.D. Va. 1963); Baltimore & O.R.R., 30 B.T.A. 194 (1934), *acq.* XIII-2 C.B. 2 (1934); Wisconsin Hydro-Elec Co., 10 B.T.A. 933 (1928), *acq.* VII-1 C.B. 34 (1928); Great N. Ry., 8 B.T.A. 225 (1927), *petition to review dismissed*, 40 F.2d 372 (8th Cir. 1930). *Contra*, Rev. Rul. 75-557, 1975-2 C.B. 33, *clarified by*, Rev. Rul. 76-61, 1976-1 C.B. 12.

18. For a view supporting the use of the so-called "application" test, see Note, *Tax Consequences of Non-Shareholder Contributions to Corporate Capital*, 66 YALE L.J. 1085 (1957).

19. 319 U.S. 98 (1943).

20. *Id.* at 103.

21. *Id.* at 102-03.

After *Detroit Edison* the "application" test appeared doomed. The Supreme Court needed only to admit its earlier mistake and thereby limit if not overturn *Cuba Railroad.* Only seven years after *Detroit Edison,* however, the Court made what appeared to be a complete about face in *Brown Shoe Co. v. Commissioner.*[22] *Brown Shoe* involved community groups from several towns that had made cash and property payments to a corporation to induce the corporation to locate a new or expanded plant in their localities or to maintain a minimum payroll. The Court held the payments and transfers were contributions to the corporation's capital rather than income to the corporation and distinguished *Detroit Edison* on the basis that the citizens groups making the contributions in *Brown Shoe* were not the corporation's customers as had been the case in *Detroit Edison.*[23] The Court did not revert to the earlier application test, but instead relied on a new test that examined the motivation of the transferor.[24]

The Court felt that *Detroit Edison* was correct to the extent it considered purchase of services or goods as determinative. The Court distinguished the facts in *Brown Shoe,* however, on the basis that the benefits to the community groups were not direct[25] but were only the expectations of advantages to the community at large. Hence, there was no payment for services as in *Detroit Edison.* It is interesting to note that, without expressly citing *Cuba Railroad* the Court in *Brown Shoe* relied upon the same distinction the Court had relied upon in *Cuba Railroad*: the distinction between payment for a direct benefit limited to the transferor or a payment for the greater good of the community at large and only indirectly for the benefit of the transferor.

C. *Congressional Response*

After *Brown Shoe,* Congress attempted to clear up the confusion in the cases by enacting sections 118 and 362(c) of the Internal Revenue Code of 1954.[26] Section 118 provided that capital contributions to corporations from any source, including contributions by nonshareholders, were not includable in gross income. Section 362(c) insured that no double benefit would accrue to a recipient corporation by providing that contributed property, or property purchased with contributed cash, was to have a zero basis, thereby foreclosing future depreciation deductions. Although these sections were an attempt to codify the existing law, they did not answer the question of how a nontaxable

22. 339 U.S. 583 (1950).
23. *Id.* at 591.
24. *Id.*
25. *Id.*
26. I.R.C. § 118 (original version at ch. 1, § 118, 68A Stat. 39 (1954)); I.R.C. § 362(c) (original version at ch. 1, § 362(c), 68A Stat. 119 (1954)).

contribution to capital was to be distinguished from a taxable payment for services.

In 1956 the Treasury Department enacted a regulation under section 118 to deal with the issue of the identification of capital contributions,[27] but the regulation was not successful in putting the question to rest. Essentially, Treasury Regulation 1.118-1 relied upon the payment for services test in identifying capital contributions by stating that a transfer was not a capital contribution if there was "any money or property transferred to the corporation in consideration for goods or services rendered." The language of the regulation did little to settle the question of what was a capital contribution because the quoted language was little more than a reiteration of the Supreme Court's holdings in *Cuba Railroad*, *Detroit Edison*, and *Brown Shoe* that payments made for goods or services are income, but payments not made for goods or services are capital contributions. The regulations failed to explain under what conditions a transfer is payment for goods or services. Furthermore, the regulations made no attempt to analyze a transfer in the light of the character of the transferor.

The principles of *Cuba Railroad* were applied in later cases without any particular discussion of the change in the character of the transferor from a government to private customers. *Brown Shoe* involved a unique sort of transferor—community groups, which lie somewhere between a private customer of the transferee whose motivation for the transfer is solely his own well-being and a government that presumably makes a contribution, at least in part, for the benefit of its citizens. The regulations failed to take transferor types into consideration in determining whether contributions are purchases of services or contributions to capital. Although presumedly the cases could be decided without reference to the character of the contributor, the courts historically were concerned with the character of the contributor. Why that concern is well founded will be discussed later.

D. *The Internal Revenue Service Steps In*

In 1958 the Internal Revenue Service broke the calm that had prevailed after the enactment of section 118 by litigating *Teleservice Co. v. Commissioner*,[28] a case dealing with contributions by would-be customers to a cable television corporation. The Service lost in the Tax Court, but succeeded in its appeal to the Third Circuit. In holding that the contributions by the customers were taxable income to the cable television company, the Third Circuit characterized the case as indistinguishable from the earlier *Detroit Edison* case. The court did not seem disturbed that the issue in *Detroit Edison* was the determi-

27. Treas. Reg. § 1.118-1 (1960).

28. 254 F.2d 105 (3d Cir.), *cert. denied*, 357 U.S. 919 (1958).

nation of basis rather than income. Instead, the court concluded that because the customers received the opportunity to purchase the cable television programming in return for their capital contributions the payments represented payments for future service. The court distinguished *Brown Shoe* and the other earlier cases by pointing out that in *Teleservice* there was a direct, personal relationship between the contributor and the corporation and that, unlike *Brown Shoe*, the payments were not intended to benefit the community at large.[29] Thus, in *Teleservice* a court relied on a distinction between private customer contributions and contributions by public or quasi-public groups for whom contribution had no direct benefit. Surprisingly, the Internal Revenue Service failed to vigorously assert this victory in later cases.

Although it did utilize the case in future cable television contribution cases,[30] the Service also issued Revenue Ruling 58-555.[31] In this rather unusual ruling the Service on its own volition limited the application of *Teleservice* and stated that it would not vary from its earlier policy of classifying as capital contributions, customer payments to regulated public utilities, which were subject to a continuing duty to provide service to its customers to cover the costs of linking up with the public utilities' lines. Having litigated that position many times since the 1920's and having for the most part lost, the Service had conceded the issue and acquiesced in those cases.[32] In Revenue Ruling 58-555 the Service inexplicably upheld its earlier acquiescence and resolved to limit *Teleservice* to its facts.

Consistency not being the strongest characteristic of the Internal Revenue Service, it was not surprising that only five years after Revenue Rule 58-555 was issued there appeared another case in which the Internal Revenue Service attempted to find taxable income in a customer contribution to a water company. The Service lost that case,[33] but finally succeeded in *Hayutin v. Commissioner*[34] by convincing both the Tax Court and the Tenth Circuit that customer payments toward the cost of water line links to a water company constituted taxable income. The Service argued, without so much as a mention of Revenue

29. *Id.* at 111.

30. Community T.V. Ass'n v. United States, 203 F. Supp. 270 (D. Mont. 1962); Warren T.V. Corp., 17 TAX CT. MEM DEC. 1053 (CCH 1958).

31. Rev. Rul. 58-555, 1958-2 C.B. 25, (*revoked by* Rev. Rul. 75-557, 1975-2 C.B. 33).

32. Baltimore & O.R.R., 30 B.T.A. 194 (1934), *acq.* XIII-2 C.B. 2 (1934); Southern Ry., 27 B.T.A. 673 (1933), *acq.* XII-2 C.B. 13 (1933), *modified*, 74 F.2d 887 (4th Cir. 1935); Union Pac. R.R., 26 B.T.A. 1126 (1932), *acq.* XII-1 C.B. 13 (1933), *modified*, 69 F.2d 67 (2d Cir. 1934), *cert. denied*, 293 U.S. 559 (1934); Tampa Elec. Co., 12 B.T.A. 1002 (1928), *acq.* VII-2 C.B. 39 (1928); Wisconsin Hydro-Elec. Co., 10 B.T.A. 933 (1928), *acq.* VII-1 C.B. 34 (1928); El Paso Elec. Ry., 10 B.T.A. 79 (1928), *acq.* VII-2 C.B. 12 (1928); Rio Elec. Co., 9 B.T.A. 1332 (1928), *acq.* VII-1 C.B. 27 (1928). Great N. Ry., 8 B.T.A. 225 (1927), *petition to review dismissed*, 40 F.2d 372 (8th Cir. 1930), *acq.* VII-2 C.B. 16 (1928); Liberty Light & Power Co., 4 B.T.A. 155 (1926), *acq.* VI-1 C.B. 4 (1927).

33. Fairfax County Water Auth. v. United States, 223 F. Supp. 620 (E.D. Va. 1963).

34. 508 F.2d 462 (10th Cir. 1974).

Rule 58-555, that regardless of the history of similar cases in the 1920's and 1930's the Supreme Court's categorization of income had sufficiently broadened to require taxability of the amounts in question.[35] In finding for the Service the court of appeals completely turned its back on the old application of proceeds doctrine found in *Cuba Railroad* and looked instead at the motivation or purpose of the payment. The court felt that *Detroit Edison* and *Brown Shoe* had established motivation of the transferor, rather than the transferee's use of the proceeds, as the determining factor.[36] In effect, therefore, the court followed *Teleservice* in finding that the motivation and circumstances surrounding the contributions indicated the payment was for future services—the supplying of water—so that the payments were taxable income to the recipient corporation.[37] The court was not concerned that the contribution was directly traceable to the capital needs of the recipient corporation. In fact, under the court's logic there could be no evidence of capital contribution under circumstances in which the transferor was to receive services.

The court in *Hayutin* had implicitly held that section 118 could never apply to the customer-contributor situation because such contributions lack an altruistic motivation. Following its success in *Hayutin* the Service pressed forward in its effort to tax customer contributions to corporations. In *State Farm Road Corp. v. Commissioner*[38] the issue was a charge for tie-in with the taxpayer corporation's sewage lines. In a strong opinion by Judge Tannenwald the Tax Court upheld the Service's contention that the customer payments were income to the recipient utility. In reviewing the history of the cases in the area, Judge Tannenwald stated: "The climate created by judicial history dealing with contributions to capital is, to say the least, strange."[39] Rather than attempting to reconcile the previous cases, however, Judge Tannenwald said the only relevant test in the classification of contributions by a nonshareholder was whether the nonshareholder was paying for services rendered. It was the motivation or purpose of the transferor that controlled and not the use to which the transferee put the money or property. Citing earlier cases, Judge Tannenwald enunciated the established test as whether "the payments had a 'reasonable nexus with the services which it was the business of the recipient corporation to provide.' "[40] Hence, the question was the

35. *Id.* at 479.
36. *Id.* at 480.
37. *Id.* at 480-81.
38. 65 T.C. 217 (1975).
39. *Id.* at 226.
40. *Id.* at 229 (citing Federated Dep't Stores v. Commissioner, 426 F.2d 417, 421 (6th Cir. 1970)).

remoteness of the anticipated benefits. Judge Tannenwald relied heavily on the reasoning found in the 1973 case of *United States v. Chicago, Burlington & Quincy Railroad.*[41]

E. *The Supreme Court Takes a Third Look: The* C,B&Q *Case*

United States v. Chicago, Burlington & Quincy Railroad concerned tax years prior to 1954 and thus prior to the enactment of sections 118 and 362(c). During the 1930's and 1940's Congress had attempted to upgrade the safety of various railroad lines through grants to states that either constructed railway improvements or reimbursed railroads for improvements that included cross signals, signs, flood lights, bridges, and other items. The CB&Q, one of the recipient railroads, attempted to depreciate the improvements. The Court of Claims in a suit for a refund held that the contributions to the CB&Q were nontaxable contributions to capital and thus were depreciable under the Internal Revenue Code of 1939. The Supreme Court granted certiorari because the Court of Claims decision apparently afforded a precedent for determining the tax treatment of "substantial sums."[42]

Justice Blackmun, writing for the majority, overruled the Court of Claims and held the contributed assets had a zero basis in the hands of the railroad. To the majority the case hinged on whether the transfers to the railroad were contributions to capital. Under *Detroit Edison,* if the transfers were not contributions to capital, the basis of the property in the hands of the railroad was zero. If the transfers were contributions to capital then under section 113 of the 1939 Internal Revenue Code the railroad would adopt the transferor's basis and would thus be entitled to a depreciation allowance. Justice Blackmun carefully reviewed the earlier Supreme Court cases in this area, *Cuba Railroad, Detroit Edison,* and *Brown Shoe* and concluded that *Brown Shoe* and *Detroit Edison* were not, as most commentators had thought,[43] in disagreement, but rather had merely arrived at different answers by application of the same test. In both cases the Court had relied on the benefit to the transferor arising from the contribution,[44] or, stated differently, the motivation of the transferor. In neither case had the Court examined the use of the contributed property,[45] and to the *CB&Q* Court this constituted a failure to use the full *Cuba Railroad* test. Reliance upon the benefit to the transferor without reference to

41. 412 U.S. 401 (1973).

42. *Id.* at 404.

43. *See, e.g.*, Note, *Taxation of Nonshareholder Contributions to Corporate Capital,* 82 HARV. L. REV. 619, 625 (1969).

44. 412 U.S. at 411. Justice Blackmun is correct in noting that both *Detroit Edison* and *Brown Shoe* relied heavily on the motivation surrounding the contributions. Nevertheless, the outcomes of the two cases seem inconsistent.

45. *Id.* at 411.

the use of the contributed capital was an improper test. Justice Blackmun found additional factors implicit in *Detroit Edison* and *Brown Shoe*, which, if properly applied to the *CB&Q* facts, would result in the proper outcome.

From those earlier cases a five part test for capital contributions was extracted: (1) a contribution must become a permanent part of transferee's working capital; (2) it must not be compensation for specific, quantifiable services provided; (3) it must be bargained for; (4) it must foreseeably benefit the transferee in an amount commensurate with the transferred asset's value; and (5) it must ordinarily be employed to generate additional income for the transferee.[46] Just where in *Brown Shoe* or *Detroit Edison* these "implicit" tests may be found is a mystery.

When the five part test was applied to the facts of *CB&Q*, the railroad lost. The assets met the first two tests because they were additions to capital and were not payment for services. The assets failed the last three tests, however, because they were not bargained for, provided only "marginal" benefit to the railroad, being "peripheral to its business, and did not materially contribute to the production of further income."[47] In summation, Justice Blackmun wrote: "In our view, no substantial incremental benefit in terms of the production of income was foreseeable or taken into consideration at the time the facilities were transferred. Accordingly, no contribution to capital was effected."[48]

Although the Court was careful not to overrule or even state the need to distinguish *Brown Shoe* and *Detroit Edison*, the outcome in the case nevertheless appears to have significantly departed from the earlier cases. Had the Court merely applied the reasoning of *Brown Shoe* and *Detroit Edison* the railroad would surely have been allowed to depreciate the assets. In *Detroit Edison* the test was whether the transferor had made the payment as a condition or precondition for services to be rendered. Clearly, in *CB&Q* no such services were involved. The federal government's position was not unlike that of the Cuban government in *Cuba Railroad*, although the United States Government in *CB&Q* did not even gain the benefit of lower rail rates that the Cuban government gained in *Cuba Railroad*. Hence, under the reasoning in *Detroit Edison* the transfer should have been classified as a contribution to capital, and under the law that prevailed prior to the enactment of section 362(c) the railroad should have been allowed to adopt the transferor's basis for purposes of depreciation.

Applying the *Brown Shoe* holding that when the benefits from the transfer accrue to the community at large rather than to the trans-

46. *Id.* at 413.
47. *Id.* at 414.
48. *Id.* at 415.

feror there is a capital contribution, it is almost impossible to distinguish the status of the federal government from that of the community groups in *Brown Shoe.* Under that test there also should have been a finding of capital contribution and a corresponding approval of the railroad's right to depreciate the carry-over basis of the transferred assets. Nevertheless, the Court thought the holding in *CB&Q* —that there was no capital contribution and thus no depreciation—did not contradict *Detroit Edison* and *Brown Shoe.*

Rather than attempting to distinguish the earlier cases, Justice Blackmun devised the elaborate five part test that he considered implicit in those cases. Even applying this test, it is not clear why the transfer of assets from the government to the CB&Q Railroad did not qualify as a contribution to capital. Why, for example, did Justice Blackmun conclude that the value of the improvements to the railroad was marginal? Although the improvements were aimed at improving safety conditions rather than improving the profit of the railroad, the reduction of accidents and the removal of sharp curves and obstacles might have allowed the trains to increase the average speed and thereby increase the efficiency and profitability of the railroad. Moreover, the railroad might have gained significant savings from tort liability and avoided the possibility that state law might have required the railroad to upgrade safety facilities at its own expense at some later date. In short, the improvements might have made possible both higher profits and lower future expenses.

Perhaps a more important question is what was the basis of the Court's assertion that the foreseeable benefit of the transferred asset to the transferee must be commensurate with its value in order to be a contribution to capital. The opinion cited no cases supporting the proposition, possibly because the position was not supported by any previous cases. This test along with the other four tests was cut out of wholecloth prepared for the occasion. It is not implausible that this case is a classic example of a result-oriented decision. The Court was aware that the CB&Q Railroad would stand to gain windfall depreciation deductions if it were allowed the transferor's cost as its adjusted basis in the improvements.[49]

Perhaps the key indicator of the Court's failure to come to grips with the issues of the case was its inability to understand the need to classify the contributions. As noted, all payments to corporations are divided into three classifications: gross income, contributions to capital, and gifts. The Court held that the transfers were not contributions to capital without indicating what the transfer represented. Because transfers were not treated as income at the time of their re-

---

49. *Id.* at 407.

ceipt,[50] it would appear that the only available classification is that of a gift. Certainly a gift is conceivable, but whether that is the correct classification is another question.

Not only is the outcome of the case dubious, but it is even doubtful whether the five-part test has really established any new standards. Close examination of the tests seems to indicate very little change from previous cases.

The Court's first test—that the item must become a permanent part of the transferee's working capital—was established initially in *Cuba Railroad* and has never seriously been challenged since.[51] The requirement that the contribution not be compensation was found in *Cuba Railroad*,[52] emphasized in *Brown Shoe*[53] and *Detroit Edison*[54] and specifically enacted in the 1956 regulations under section 118. The Court's language offers nothing more useful or helpful in classifying payments than the regulations, which are models of vagueness.

By the third requirement—that the contribution be bargained for—the Court is apparently looking for some way to distinguish between a contribution and a gift; but surely there are already more than enough tests for identifying gifts.[55] The fourth test—that the transferred assets foreseeably result in benefit to the transferee commensurate with its value—is vague and almost impossible to apply. Benefit is a slippery concept. As seen in *CB&Q*, while it is easy enough to state that no commensurate benefit is enjoyed by the transferee, it is another matter to prove such an assertion. Moreover, the test does not necessarily distinguish contributions of capital from other transfers to a corporation. Payments that are gifts or income may also have a value to the recipient corporation equal to their value in the hands of the transferor. In any event the only relevant test of benefit is the fifth test—that the contributed asset ordinarily produce income, or reduce expenses for the recipient corporation.

Corporations determine the benefit or value of potential assets by one of two tests. The first test is the sale value of the asset on the open market. The second test is the rate of return or rate of profit the asset can be expected to generate if retained.[56] The first test is, of

---

50. *Id.* at 408.

51. Edwards v. Cuba R.R., 268 U.S. 628, 632 (1925).

52. *Id.* at 633.

53. Brown Shoe Co. v. Commissioner, 339 U.S. 583, 591 (1950).

54. Detroit Edison Co. v. Commissioner, 319 U.S. 98, 103 (1943).

55. *See, e.g.*, Commissioner v. Duberstein, 363 U.S. 278 (1960).

56. An item of no value could be considered not a capital item because it would not have to be included on the balance sheet of the corporation. An item with a lower value in the hands of the recipient corporation than in the hands of the transferor will nonetheless be included in the capital assets of the transferee. A regulated public utility that cannot include the contributed property for ratemaking purposes, however, will not earn any rate of return from the contribution. The contributed property is arguably not a capital asset in the hands of the utility.

course, merely an intermediate step toward the second test because the fair market value of productive assets is a function of the rate of return that the asset can earn or the extent to which the asset can reduce otherwise unavoidable costs. Thus, all assets are valuable to a corporation only to the extent the assets contribute to the profitability of the corporation.[57] What Justice Blackmun was saying in the fourth and fifth part of his test is that it is possible for the transferor to contribute assets that are of great value to the transferor even though the assets have little or no value to the transferee corporation because the asset either (a) cannot be sold or traded on the open market, or (b) will not produce an adequate rate of return.[58]

The facts in *CB&Q* suggest certain implicit assumptions made by the Court. The Court apparently felt that the government's motivation in transferring the property to the railroad was to promote the public benefit. This test alone would qualify the contribution as a contribution to capital under *Brown Shoe.* Because the Court in *CB&Q* felt that motivation was equal evidence of donative intent, it required that the transfer pass a second test: whether the items transferred had a commensurate value to the transferee.[59]

If the "benefit or value to the transferee" test is applied in the context of the earlier cases, the outcome in those cases is not affected. In *Cuba Railroad*, for example, the transferred rail lines clearly had benefit or value to the transferee. In *Detroit Edison* the test was never reached because the motivation test clearly revealed a payment for services. In *Brown Shoe* the motivation of the transferor was found consistent with a contribution to capital because the transferor recognized only an indirect benefit. The second test—benefit or value to the

57. The Court in *CB&Q* never addressed the question of when the value of transferred items should be determined. Should the value of the transferred assets be tested after some indeterminable time, or is it enough that the transferor reasonably *expects* that the transfer will produce economic benefits to the transferee? Surely the answer must be the latter; otherwise, determining the classification of the transfer could not be done at the time of the transfer. The parties (and the Internal Revenue Service) would be forced to wait in order to determine if transferred assets were of any value to the transferee. And if the transferred assets were apparently without value to the transferee, would it be arguable that a more economically skillful transferee would have found a way to make the transferred asset valuable to its business? The test of the value of transferred assets, therefore, must occur at the time of the transfer. If the transferor is reasonable in assuming that the transferred property has value to the transferee, there is no reason not to classify the transfer as a contribution to capital, even though the possibility remains that the transferred assets may turn out to have no value to the transferee.

58. An example of such an asset would be a piece of sculpture that is fixed in place at a certain geographical location. Imagine that the creating artist donated the sculpture to a corporation. Further postulate that the cost of materials in producing the sculpture was $100x$ dollars. The artist deeds title in the sculpture to the corporation. The corporation cannot use the sculpture in any way to produce a profit. Moreover, if the sculpture is not movable, its location may be so undesirable that no one will want to buy the sculpture. Thus, the sculpture has no value to the corporation. Under the *CB&Q* test, regardless of the artist's motivation in deeding the sculpture to the corporation, the transfer could never be considered a contribution to capital because the item transferred has no economic benefit to the corporation.

59. 412 U.S. at 413.

transferee—was easily satisfied because the transferred asset was a manufacturing plant.

If a transferor transfers property to a transferee under the reasonable belief that the transferred property has value to that transferee, it follows that the transferor was motivated, at least in part, to engage in the transaction for the benefit of the transferee. Of course, as in the case of *Brown Shoe*, benefiting the transferee may be only a means to an ultimate end, for example, benefiting either the transferor or some third party. If the transferor is motivated to aid the transferee and acts in a manner reasonably likely to produce a benefit for the transferee, the transfer should be classified as a contribution to capital. In short, just as all roads lead to Rome, so do all tests of contributions to capital lead to an examination of the motivation of the transferor. The particular test of *CB&Q* is, if not particularly useful, at least not incorrect. Unfortunately, because *CB&Q* is a Supreme Court decision, it may be considered a "landmark" decision. If that occurs the confusion in the area will only increase because the case essentially adds nothing new. The so-called "benefit or value to the transferee" test is only an additional means of examining the motivation of the transferor.

F. *Shopping Center Developers Discover Section 118*

Up to this point all contributors have been classified as either (1) a government, (2) a quasi-governmental or community body, or (3) a private individual or customer. While the Internal Revenue Service and the CB&Q Railroad were litigating the issue of deductibility there developed a series of cases involving contributions by a fourth category of contributors—shopping center developers.

To the extent the shopping center developers consist of individuals or corporations, they are analogous to the third category. They can be distinguished, however, by the nature of the intended benefit that motivates the contribution. The benefit to the transferor is indirect because private individuals or corporations make contributions without any expectation that the transferee will provide future services. In the third category such as in *Teleservice* or in the case of a contribution by a customer to a public utility, however, the link between contribution and future services is direct because the capital contribution is a precondition to receipt of services. In the context of a shopping center development, a transferor subsidizes a transferee in order to induce the transferee to locate in transferor's shopping center. In a sense, such a subsidization is a combination of the *Brown Shoe* situation, in which a subsidy involving choice of location is involved, and *Detroit Edison*, in which the transferor was an individual or corporation subsidizing another corporation or individual not for the general good of the community but for the specific benefit that would accrue to the transferor.[60]

60. Those who develop shopping centers have long known that the success or failure of a

The Internal Revenue Service has challenged the application of section 118 to department stores that receive a subsidy in order to locate in a particular shopping center. In the initial case that came before the Tax Court, *Federated Department Stores, Inc. v. Commissioner*,[61] the developer granted the taxpayer-department store ten acres of free land and agreed to pay the department store $200,000 a year for ten years to induce the store to locate in the developer's shopping center. The taxpayer-department store constructed a building worth approximately $2 million and opened the department store, treating the transfer of land and annual payments as nontaxable contributions to capital under section 118. Taxpayer correspondingly claimed a basis in the building equal to the construction cost minus the value of the subsidy as provided by section 362(c). The Service argued the cash payments were income to the taxpayer[62] and proposed that for purposes of depreciation taxpayer be granted an increase in the adjusted basis equal to the taxable subsidy of the building.

The Service's main contention was that payment to taxpayer was primarily motivated by the developer's desire to increase the value of the shopping center. Thus, the Service reasoned, because the dominant, if not sole, motivation was to benefit the transferor, the transfer failed to qualify under section 118. The Tax Court held unanimously (with two judges not taking part in the case) that the subsidies qualified as contributions to capital under section 118.[63] Without disputing the contention of the Service that the dominant test was the motivation of the transferor, the court held that when a transfer was motivated only by the transferor's anticipation of indirect benefits, there existed

---

shopping center depends upon attracting a sufficient number of customers to the center. The relationship of the stores within a shopping center is symbiotic in that many of the stores could not individually attract sufficient patrons to warrant locating within the center. Each store is dependent upon the drawing power of the other stores. Two principles explain this dependency. The first principle is that customers may be attracted to the center merely because of the number of stores located there. A customer can be assured that whatever he or she may be searching for will be sold by one or more of the stores. The second principle is the spin-off theory, which states that customers attracted to a location because of store A may also patronize store B merely because of the convenience it offers. On the basis of the spin-off theory, a small specialty store that might not attract sufficient customers if located in isolation will locate next to a larger or more prestigious store that independently draws customers. Thus, in order to insure that the center will be successful, a developer must have a full-line department store which is well known in the area. By its reputation this anchor store will ensure the success of the shopping center.

As more and more shopping centers have developed it has become more difficult for developers to attract these full-line department stores into their developments. So difficult, in fact, that some developers are now prepared to grant subsidies to major department stores to induce them to locate in the developer's shopping centers. The subsidies consist of either land or a building given to the department store or reimbursement to the store for the cost of its building. The department store receiving the subsidy reports the transaction as a contribution to capital, which qualifies for section 118 treatment, and presumably the developer deducts or amortizes the cost of the subsidization.

61. 51 T.C. 500 (1968), *aff'd*, 426 F.2d 417 (6th Cir. 1970).

62. The tax treatment of the transfer of the land was not raised as an issue in the case.

63. 51 T.C. at 520.

a contribution to capital. The court apparently felt the issue was obvious because it did not engage in any close reasoning or argument, but simply stated the conclusion and cited the older cases in the area, including *Cuba Railroad.*

The court also relied heavily upon the historical background of section 118 and quoted from the Senate Finance Committee Report on the section. The court was persuaded by the Senate committee's language which stated that a contribution to capital existed whenever the transferor was to realize "an intangible future benefit . . . so intangible as to not warrant treating the contribution as a payment for future services."[64] The court did not bother to analyze how or why the case before it fit the quoted language. Nor did the court bother to discuss the fact that both section 118 and the committee language arose shortly after *Brown Shoe.* Arguably, the language used by the Senate committee applied to a contribution whose hoped-for benefits were to be enjoyed not only by the contributor but also by the community in general, as in *Brown Shoe.* Moreover, the quoted committee language was taken from a context that distinguished contribution to capital payments from gifts. The full quotation states: "In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services."[65]

On appeal to the Sixth Circuit Court of Appeals[66] the Service added a second argument to its original argument that if the transferor was motivated by the benefits to be realized by the transferor rather than any concern for the general welfare of the community, the transfer should be classified as income to the recipient. The second argument was that section 118 should be limited to transfers by a governmental unit or a civic group. In rejecting this argument the Sixth Circuit pointed out that Treasury Regulation 1.118-1, which provides that capital contributions may be made by a governmental unit or civic group, is to be read only as illustrative and not as a definitive limitation on the qualifications of contributors of capital.[67] Moreover, the Senate Finance Committee language had specifically referred to any "association of individuals having no proprietary interest in the corporation"[68] as a source of nonstockholder contributions to capital.

The government's first contention with respect to the motivation

64. *Id.* at 519.

65. S. REP. No. 1622, 83d Cong., 2d Sess. 18, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4025, 4042.

66. Federated Dep't Stores Inc. v. Commissioner, 426 F.2d 417 (6th Cir. 1970).

67. *Id.* at 422.

68. S. REP. No. 1622, 83d Cong., 2d Sess. 18, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4025, 4042.

of the transferor was again not treated as determinative in the characterization of the payment. The appellate court held that the expectation of profit by the transferor was "of such a speculative nature that any benefit necessarily must be regarded as indirect."[69] The court found that the contributions did not have a reasonable nexus with the services to be provided by the transferee, and, therefore, the transfer was classified as a contribution to capital. Although the court relied heavily upon *Brown Shoe*, it did not acknowledge the different nature of the motivation that induced the subsidy in *Brown Shoe* as opposed to the motivation of the shopping center developer.

An almost identical case, *May Department Stores Co. v. Commissioner*,[70] arose two years later. Once again a shopping center developer induced the location of a prime tenant through a subsidy consisting of free land. The Service argued that the indirect and intangible benefits test could only be applied to a contributor who enjoyed those benefits as a member of the community at large and not in the capacity of a shopping center developer. In finding for the taxpayer, the Tax Court held that such a restricted notion of who could receive indirect or intangible benefits was incorrect and that so long as the benefits enjoyed by the shopping center developer were in fact only indirect and intangible the developer qualified as a possible contributor of capital.[71] The Service appealed to the Eighth Circuit, but lost in a per curiam opinion.[72]

Although the Service lost on the shopping center front, it was more successful under a slightly different factual situation. In *John B. White, Inc. v. Commissioner*[73] the Service convinced the court that a corporation operating a Ford dealership received taxable income when the corporation received payment from Ford Motor Co. to locate in a more desirable neighborhood. The court distinguished the earlier *Federated Department Stores* case on the basis that the benefits in *Federated Department Stores* were indirect or intangible while the anticipated benefits in the present case had a reasonable nexus to the services provided by the taxpayer corporation. The court concluded that the dealer provided services in the form of the sale and promotion of Ford products and that Ford paid the subsidy with the expectation that the new location would result in greater sales and better promo-

69. 426 F.2d at 421.

70. 33 TAX CT. MEM. DEC. 1128 (CCH 1974), *aff'd per curiam*, 519 F.2d 1154 (8th Cir. 1975).

71. *Id.* at 1130.

72. May Dep't Stores Co. v. Commissioner, 519 F.2d 1154 (8th Cir. 1975).

73. 55 T.C. 729 (1971), *aff'd*, 458 F.2d 989 (3d Cir. 1972).

tion of Ford products. Because the court considered the subsidy motivated by considerations that were directly beneficial to Ford, it concluded that the subsidy could not meet the indirect benefit test of section 118 and therefore represented income to the recipient. The court recognized that the case was very similar to *Federated Department Stores* and characterized the line between the two cases as "a shadowy one."[74]

II. ECONOMIC AND LEGAL ERRORS IN THE SHOPPING CENTER CASES

The holdings in *Federated Department Stores* and *May Department Stores* appear wrong both as a matter of law and economics. If the courts in those cases had correctly applied the tests originally outlined in *Cuba Railroad*, they would not have erred. The original *Cuba Railroad* test was a three-fold test. First, the form of the subsidy was irrelevant; both cash and property could represent either income or a tax-free contribution to capital. Second, in order to be a capital contribution the transferred cash or property had to be traceable to the capital accounts of the transferee. Third, the payment could not be made for services rendered or to be rendered.[75] The facts in both *Federated Department Stores* and *May Department Stores* appeared to satisfy the first two parts of the test. The courts went astray, however, when they applied the third test—payment for services rendered. The third part of the *Cuba Railroad* test was created against the backdrop of a governmental subsidy. In that context the most significant benefits, according to the Supreme Court, accrued to the population of Cuba and only to a lesser extent to the Cuban Government.[76] The benefits described by the Court in that case were, to use the language of later cases, "indirect benefits."[77]

---

74. *Id.* at 737.

75. 268 U.S. 628, 632 (1925).

76. From an economic standpoint the development of a railroad as in *Cuba Railroad* is tremendously important to the economic development of a country. The benefit to the Cuban population from the development of the railroad was two-fold. First, the railroad was a means of transportation for the population. Second, and more important, the railroad played an important if not decisive role in the economic development of the country. A government benefits indirectly from such benefits to its population. If the government believes its existence is justified or predicated upon service to the population, the government is benefited by having its obligation to aid the citizenry fulfilled by the railroad. Regardless whether the government feels an obligation to improve the economic position of its population, the government will nevertheless benefit if the economy of the nation is improved because an improved economy generally aids the government's position vis a vis both its domestic and foreign opponents and more particularly, because the improved economy may generate greater tax revenues.

77. *See* Federated Dep't Stores, Inc. v. Commissioner, 426 F.2d 417, 421 (6th Cir. 1970); May Dep't Stores Co. v. Commissioner, 33 TAX CT. MEM. DEC. 1128 1130 (CCH 1974), *aff'd*, 519 F.2d 1154 (8th Cir. 1975).

Unless the subsidy by the Cuban government is imputed to the population of Cuba, one must conclude that the population in *Cuba Railroad* did not pay for the benefits that it received. Hence, party *A*, the Cuban government, made payments to party *B*, the railroad, for benefit of a third party *C*, the population of Cuba. It is, of course, possible to classify payments for benefit of a third party as income to the transferee. Perhaps that would have been the wisest thing to do. Short of repealing sections 118 and 362(c) of the Internal Revenue Code and overruling *Cuba Railroad* and its progeny, however, one must accept the nontaxability of such transfers. Nevertheless, the class of transfers denoted as nontaxable contributions to capital should be narrowly construed. If not, more and more taxpayers will arrange transactions to come within the protection of section 118.[78]

A major feature distinguishing *Cuba Railroad* from many later cases that would allow a narrow construction of the transfers is the character of the transferor. When the transferor is a foreign or domestic governmental unit, the tax classification of the transfer is irrelevant with respect to the transferor because a government is not subject to the United States Internal Revenue Code. Nonprofit civic associations, such as in *Brown Shoe*, are similarly exempt from taxation.[79] The nontaxability of the transferor in the case of governmental units or civic associations means the cost of the transfer to the transferor will not be written off as an income tax deduction.

If the transferor is a taxable entity it is possible—and probable, thanks to the liberal net loss carry forward provisions[80]—that the transferor will be able to deduct the subsidization cost. If transferor, for example, contributes $100 to transferee in a manner qualifying under section 118, transferor will have a deduction of $100, but there will not be a corresponding increase of $100 in the income of the transferee in the year in question.

When the transferor is a taxable entity, the classification of the transfer is critical with respect to federal tax revenues. If the transfer qualifies under section 118, the potential loss to the government is the tax on $100, which if the transferor is a corporation taxed at the 48% rate[81] is forty eight dollars.[82] Of course, if the $100 of value is a de-

78. The leading exponent of eliminating deductions from the Internal Revenue Code is Stanley Surrey who thinks tax incentives are an undesirable way to promote public policies. *See* Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352 (1970). Whether Surrey would consider section 118 to be a tax expenditure or tax incentive is unknown. Nevertheless, minimizing deductions is on the whole a desirable objective. *But see* Bittker, *A "Comprehensive Tax Base" As a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967).

79. I.R.C. § 501(c)(4).

80. I.R.C. § 172.

81. I.R.C. § 11.

82. Under certain conditions when the transferor's realized benefit of the subsidy has a measurable life, the transferor may be required to amortize the subsidization deduction over a

preciable item or is used to purchase a depreciable item, then because of section 362(c), the tax loss to the government is one of deferral rather than total avoidance. The transferee has in effect "lost" $100 of depreciation deductions. Because money has value over time, however, delaying collection of the tax is a net loss to the government in real dollars. Moreover, if the item purchased for cash or transferred is not depreciable, such as land, or has a relatively high salvage value, and to that extent is not depreciable, the potential tax deferral is much greater. The deferral will exist until transferee sells or exchanges the item in a taxable transaction at which time the lower basis caused by section 362(c) may result in higher taxable income to the transferee.

It is possible, however, that the tax deferral may become tax avoidance through the operation of section 1014 at the death of a noncorporate transferee, which results in a partial "stepped-up basis" that will avoid the penalty of section 362(c).[83] Moreover, if the delay in the sale is long enough the discounted value of the later tax payment may be great enough to constitute de facto tax avoidance. Additionally, inflation may so lessen the value of the dollars used to pay a deferred tax that substantial tax avoidance in effect will occur. It is also possible that the transferee may exchange the subsidized property in a tax-free manner,[84] thereby greatly extending the tax deferral. Finally, if the transferee uses the subsidy to purchase land or any other capital asset, gain realized from a later sale will be taxable at capital gains rates.[85] The transferor, of course, will have taken the cost of the deduction against ordinary income. Thus, it appears the classification of an item under section 118 gives rise not only to tax deferral, but may also encourage tax avoidance.

III. THE RELATIONSHIP OF CONTRIBUTORS AND BENEFITS

A. *Customer Contributions and Utilities*

It was noted above that *Cuba Railroad* was quickly extended to cases in which the transferor was an individual rather than a government.[86] When utility customers, as a precondition to receiving ser-

period of years equal to such life. The shopping center developer who "donated" a building to Federated Department Stores, for example, probably amortized the cost of the building over its useful life. Query whether such amortization would still be required if the subsidy were repayment to the store for the cost of erecting its own building? Arguably, such repayment would have to be amortized over the life of the building. The effect the timing of the deduction for transfer upon the *form* of the subsidy to the transferee certainly belies the claim that the connection between the subsidy and the benefit to the transferor is too "indirect" to warrant taxing the transferee.

83. I.R.C. § 1014. The effect of this section has been diminished by the limitation on the step-up of basis in § 1023 enacted in the Tax Reform Act of 1976, P.L. No. 94-455, 90 Stat. 1525.

84. *See* I.R.C. §§ 1031, 1032, 1033.

85. I.R.C. § 1201.

86. *See* notes 14-15 *supra* and accompanying text.

vice, paid a "capital assessment" for the cost of extending the utility lines to their homes, the payments were held nontaxable contributions to capital.[87] In such cases loss of tax revenue to the government did not arise from the transferor claiming a deduction, because they were generally private individuals for whom the cost of obtaining the utility link-up was not a deductible item. The loss of revenue to the government arose, therefore, only to the extent the utility was able to defer or avoid taxation. Thus, the utility cases are analogous to *Cuba Railroad* in that the transferor in both cases did not take a deduction equal to the cost of the subsidy.

The utility cases do differ from *Cuba Railroad* in at least one important respect. In *Cuba Railroad* significant benefits accrued to individuals who were third party beneficiaries. Moreover, the benefits to the transferor government were at best vague and indefinite. In the case of utility customer contributions to capital, there is no third party beneficiary, and the benefit to the transferor is direct and specific. Nonetheless, in both cases the benefit is not economic. The well-being of the transferor, to be sure, is enhanced by the subsidy, but the receipt of electrical power is not a taxable event for the customer.

In *Brown Shoe* there is yet another type of subsidizing body—the civic association. Here, although the civic association-transferor that directs the subsidy does not receive economic benefits per se, its members most certainly hope to realize such benefits. The civic association may, of course, realize a benefit on account of added membership both from the new concern entering the community and from the general economic growth that may result from the addition of a new manufacturing plant. Surely, however, the prime motivation behind the subsidy is not to aid the civic association per se, but to benefit its members by means of increased economic activity; however, that is not the only benefit that will be realized.

B. *Benefits*

In the case of a subsidy by a civic association, there are at least three categories of possible benefits: 1) the benefits enjoyed by the contributing civic association; 2) the benefits enjoyed by the contributors who comprise the civic association; and 3) the benefits enjoyed by individual citizens or businesses that are not members of the civic association or that do not contribute to the subsidization activity. The individual citizens may benefit from a new job or higher wages. Noncontributing businesses may also benefit from the increased economic activity. This third benefit category is similar to a gift from the transferor to the benefiting party. The benefits realized by the

87. Liberty Light & Power Co., 4 B.T.A. 155 (1926), *acq.* VI-1 C.B. 4 (1927); *see* Fairfax County Water Auth. v. United States, 223 F. Supp. 620 (E.D. Va. 1963); Rev. Rul. 58-555, 1958-2 C.B. 25 (*revoked by* Rev. Rul. 75-557, 1975-2 C.B. 33).

area citizens and the noncontributing businesses place them in the category of gratuitous beneficiaries. The benefits to them are perhaps predictable and expected, but are not the motivation for the contribution.

The existence of gratuitous beneficiaries demonstrates that any locational choice by a manufacturer or any economic activity undertaken as a result of a capital contribution has benefits that cannot be limited to the contributor or to a desired group of beneficiaries. These "spin-off" benefits give rise to transfers difficult to classify. It is only a short step from a transferor making a contribution in order to achieve the direct X benefits and disregarding the advantages of Y spin-off benefits, to the point where the contributor makes the contribution motivated not by the most obvious direct X benefits, but in order to enjoy the Y spin-off benefits. Analysis, therefore, of the types of economic benefits that may be realized is crucial.

One method of classifying benefits is to divide them into the following three vague areas:

1) Direct benefits.
2) Intermediate benefits.
3) Indirect benefits.

Direct benefits are benefits that result from enjoyment of the product to be produced by the transferee. In the case of a water company, the primary benefit to be realized by the contributor is the availability of water. Similarly, the primary benefit obtained from an electric company is the electricity generated by the transferee. There are other cases in which products produced by the transferee are needed by the transferor. Thus, the transferor or his agent, for example, a civic association, contributes to the transferee in order to induce the production of the desired product. A construction company, for example, might induce by means of a capital contribution the nearby location of a cement manufacturer.[88]

Intermediate benefits are benefits that arise from the direct participation by the benefiting parties in the economic activities of the transferee. A local government might subsidize the location of a manufacturing plant in order that its constituents benefit through jobs in the plant. Similarly, local businessmen might contribute through their civic association to the subsidization of an assembly plant to be located in their vicinity. They contribute with the expectation that they will be able to sell goods and services to the assembly plant.

Indirect benefits are all other benefits that might be realized as a consequence of a locational decision or economic activity to be undertaken by the transferee. An example might be local businessmen

---

88. *See* Arundel-Brooks Concrete Corp. v. Commissioner, 129 F.2d 762 (4th Cir. 1942).

who induce the location or expansion of manufacturing plants in the region in the expectation that the region's general economic climate will improve and thus increase the businessmen's sales. A local municipality might make subsidies in order to increase the economic activity in the area and thereby generate additional tax revenues from sales or income taxes.

If it is possible to distinguish between three or more different kinds of beneficiaries and three types of benefits, it is apparent that there will be many combinations of beneficiaries and benefits. Perhaps it is this multiplicity of combinations that accounts for the apparent confusion in the treatment of the cases by the various courts. All too often, the courts have failed to sort out the precise parameters of the case.[89] For example, if a municipal government subsidizes the ACME Widget Plant to locate in its community, who is the beneficiary and what is the form of the benefit? One can imagine at least some of the motivations behind the subsidy or contribution. The local government may rely heavily upon a property tax for revenue and perceive a direct benefit in the form of greater tax revenues. The government pays now with the expectation that the company will pay later. There is also the possibility that the municipal government intends to benefit not only itself, but its constituents as well. In fact, the government may be acting merely as an agent for its constituents.

The benefits to the citizens probably encompass all three varieties previously described. First, citizens who need the products to be produced by the subsidized manufacturing plant receive the direct benefit of a convenient source of widgets. Some citizens will be future employees of the ACME Widget Plant and realize intermediate benefits in the form of wages. Still other citizens will indirectly benefit from the mere increase in economic activity. For example, the local retail stores may make more sales as a result of the payroll produced by the ACME Widget Plant. Other citizens who are content in their present jobs may find that the new employer in the area will cause a general rise in wages. This example demonstrates that all three types of benefits may be realized from a single subsidization.

The example also contains a variety of beneficiaries. First, benefits will accrue directly to the contributing municipal government. Next, benefits will accrue to the constituents of the contributor, realistically, composed of only a few, select individuals or classes who may have been responsibile for the subsidization. Furthermore, benefits will, in most instances, accrue to third party or gratuitous beneficiaries. For example, towns or counties surrounding the subsidizing community may benefit from the location of the ACME Widget Plant.

89. A tradition was established by *Cuba Railroad*—with the Supreme Court seemingly more concerned with the labels attached to the activity than with the underlying economic reality.

A motel by the highway that leads to the plant may realize increased business. The railroad or truck companies in the area may also realize increased business. In any contribution situation one can expect to find an almost endless number of possible beneficiaries enjoying a variety of benefits. It is far from clear, however, that the courts have always appreciated the complexity inherent in these cases.[90]

The above example points out that every business decision that causes an increase in business activity or that is concerned with a locational decision produces a variety of economic benefits. These benefits are not limited to individuals or concerns that have direct dealings with the manufacturing concern. The indirect or "spin-off" benefits may be even more valuable. The degree of value and those to whom it may be valuable is not always clear. Business activity also produces detrimental spin-offs. Again, who is injured or harmed and to what extent is also often indeterminable. The only generalization possible is that any economic activity has a variety of spin-off effects. Moreover, the corporation or other generator of the economic activity that creates spin-off value generally is incapable of allocating the value of such spin-offs to any particular party.

Thus, in the example above, suppose ACME Widget Plant has decided to build a new plant. It is probably not feasible for ACME to direct to any particular party the increased motel accommodation business that may result from its locational choice. But it is possible that an interested party could predict the existence of the spin-off economic activity and as a consequence might try to influence ACME's choices in order to benefit from the potential spin-off economic activity. Thus, the motel operators of community X might urge their community to subsidize ACME by granting it tax rebates, or the operators might contribute themselves to the subsidization in some small way. Realistically, all parties that contribute or urge their agents or local governments to contribute subsidies of capital contributions do so expecting one of the three forms of benefits already discussed. If no such benefits are realized either for the contributor or some beneficiary of his choosing then the contribution should be considered a gift.

In short, contributors or their agents make investments upon which they hope to realize an economic return. Although it is possible to differentiate between an assured or speculative return, or among direct, intermediate, and indirect benefits, such distinctions are fundamentally irrelevant. In all these situations the motive remains the same: businessman *A* expends X dollars hoping for a return of Y percent. The contributing businessman is not concerned with the type or

---

90. For example, note the lack of sophisticated investigation in Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), with respect to the nature of the benefits.

the source of benefit expected. It is enough that there is benefit. Following classical capitalist economic doctrine the rate of return that he requires is a function of the speculativeness or risk of his investment.[91] Thus, the more indirect or speculative the benefit, the greater the potential benefit must be to warrant the assumption of risk.[92] It is the risk factor that determines the amount and conditions under which the businessman or his agent will make the investment.

From an economic standpoint, therefore, it is senseless to differentiate the income tax treatment of the transferee according to an alleged varying motivation of the transferor because there is no "varying" motivation. All transfers have at their source a single motivation—the hope for economic benefits. If one is to distinguish between taxable and nontaxable contributions one must abandon the motivation test in favor of examining the economic circumstances that surround the transfer.[93]

IV. THE ATTEMPTS OF CONGRESS AND THE INTERNAL REVENUE SERVICE TO DEAL WITH CUSTOMER CONTRIBUTIONS

If the motivation test does not provide the means to distinguish section 118 transfers from income to recipient transfers, must section 118 by its nature cover transactions that it ought not cover, or should it be read so narrowly that it excludes transfers Congress intended it to cover? The regulations seem to indicate an indirectness of benefit test to identify capital contributions.[94] As already demonstrated, however, an economic benefit is a benefit regardless whether it is direct or indirect. The regulation, therefore, does not aid in the analysis.

Earlier this article divided all transferors into four classifications and noted that in *Federated Department Stores* the Internal Revenue Sèrvice argued that only governmental or civic groups were eligible to be transferors of capital contributions. The Service did not succeed in this attempt to limit qualifying capital contributions. As a practical matter, however, the Service has been successful in severely limiting the nature of the section 118 transferor.

Under current case law, contributions from government or quasi-governmental groups may qualify as capital contributions.[95] Private

91. *See* R. MILLER, ECONOMICS TODAY 237 (1973).

92. The two are not necessarily correlative. It is possible that indirect benefits may be more assured in certain instances than direct benefits.

93. For support of the motivational test, see Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950); Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943); United Grocers Ltd. v. United States, 308 F.2d 634 (9th Cir. 1962).

94. Treas. Reg. § 1.118-1 (1960).

95. Brown Shoe Inc. v. Commissioner, 339 U.S. 583 (1950); Edwards v. Cuba R.R., 268 U.S. 628 (1925).

individuals or customers, on the other hand, have little hope of making successful capital contributions after the holding in *Teleservice*.[96] In 1975, the Internal Revenue Service attempted to further limit customer contributions qualifying for section 118 treatment by issuing Revenue Ruling 75-557[97] and a later qualifying Revenue Ruling, 76-61.[98] In Revenue Ruling 75-557 the Internal Revenue Service relied upon *Chicago, Burlington & Quincy Railroad*[99] and *Hayutin*[100] and held that henceforth all customer contributions to regulated utilities representing connection fees for the construction or insulation of service lines and water meters were includable in the gross income of the public utilities. The revenue ruling overruled a policy that had been in effect since the 1926 *Liberty Light & Power* Co.[101] case and consequently overturned fifty years of tax accounting. The Internal Revenue Service, which had ignored its gains in *Teleservice*, finally, after *Chicago, Burlington & Quincy Railroad* and *Hayutin*, attempted to tighten the definition of a capital contribution in the area of customer contributions. In effect, the ruling extended the *Teleservice* doctrine to regulated public utilities, specifically a water company.

A congressional response was quick in forthcoming. Among the myriad provisions of the Tax Reform Act of 1976 was a little publicized section amending section 118.[102] Although the congressional reports do not indicate the rationale behind the amendment to section 118, it can be presumed that the utility companies were influential in its promulgation.[103] Section 118(b), which modified section 118, provides that customer contributions for water and sewer line construction are nontaxable capital contributions to the recipient utility.[104] Capital

96. Teleservice Co. v. Commissioner, 254 F.2d 105 (3d Cir.), *cert. denied*, 357 U.S. 919 (1958).

97. 1975-2 C.B. 33.

98. 1976-1 C.B. 12.

99. 412 U.S. 401 (1973).

100. Hayutin v. Commissioner, 508 F.2d 462 (10th Cir. 1974).

101. 4 B.T.A. 155 (1926), *acq.* VI-1 C.B. 4 (1927).

102. Tax Reform Act of 1976, P.L. No. 94-455, § 2120, 90 Stat. 1525, 1912.

103. *See* N.Y. Times, July 20, 1976, at 15, col. 1.

104. H.R. 10612 as originally passed in the House contained no amendments to I.R.C. § 118. The first suggestion of amendment came with the Senate Finance Committee Report, S. REP. No. 94-938, 94th Cong., 2d Sess. 435-36, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, which was filed on June 10, 1976. The committee recommended that contributions in aid of construction received by water and sewage disposal utilities "from an existing or potential customer, a builder or developer, a governmental body, or any other person should constitute a contribution to capital." To qualify for capital contribution treatment, the committee recommended the following requirements: (1) the amounts received by the utilities must be for qualified expenditures, "an amount which is expended for the acquisition or construction of tangible capital assets, where the acquisition or construction of the facility was for the purpose of motivating the contribution"; (2) the capital assets acquired must be used predominantly (80%) in the trade or business of furnishing water or sewage services to the utility customers; (3) the expenditures must occur by the end of the third taxable year; (4) any amounts received but not directed towards the cost of the facility must either be returned to the payer or claimed as income by the utility; (5) the amounts received are not to be included in

contributions are defined in section 118(b)(1) to include money or property received from any person by a regulated public utility providing water or sewage disposal services if the amount was a contribution in aid of construction and the amounts were not included in the utilities' rate bases for rate-making purposes.

Section 118(b) also introduced the "expenditure rule," which requires that amounts claimed as capital contributions qualify as such only if the recipient utility expends an amount equal to the contribution for the construction or acquisition of section 1231(b) property used in furnishing water or sewage disposal services. Moreover, the expenditure by the utility must occur within two years of the receipt of the contribution. Finally, the utility may not depreciate or claim an investment credit for the contribution. The amendment to section 118 became effective February 1, 1976, which was also the effective date of Revenue Ruling 75-577.

---

the utility's base rate for rate-making purposes; and (6) no depreciation or investment credit will be allowed with respect to any property acquired as a result of a qualified expenditure.

The Finance Committee gave as an example of a qualifying contribution the situation in which a customer pays a fee (connection fee) to reimburse the utility for lines that are turned over to the water and sewage disposal utility.

The Senate passed H.R. 10612 with amendments on August 6, 1976.

The Conference Agreement to the Tax Bill, H.R. REP. No. 94-1515, 94th Cong., 2d Sess. 223, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4118, 4205, adopted the Senate recommendations with some modifications. The two most important modifications made in the Conference Agreement with respect to the section of the Finance Committee Report dealing with capital contributions were: (1) § 1321 of the Conference Agreement explicitly excludes from capital contribution treatment connection fees paid by customers (or potential customers) of the utilities; and (2) § 1321 reduces by one year the time after receipt of the contribution within which the utility is required to make the qualifying expenditure.

Both the Senate and the House adopted the Conference Agreement on September 16, 1976.

The capital contribution section (§ 2120) of the Tax Reform Act as signed by President Ford on October 4, 1976, amended I.R.C. § 118 to read as follows:

SEC. 118. CONTRIBUTIONS TO THE CAPITAL OF A CORPORATION

(a) GENERAL RULE.—In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

(b) CONTRIBUTIONS IN AID OF CONSTRUCTION.—

(1) GENERAL RULE.—For purposes of this section, the term "contribution to the capital of the taxpayer" includes any amount of money or other property received from any person (whether or not a shareholder) by a regulated public utility which provides water or sewage disposal services if—

(A) such amount is a contribution in aid of construction,

(B) where the contribution is in property which is other than water or sewage disposal facilities, such amount meets the requirements of the expenditure rule of paragraph (2), and

(C) such amounts (or any property acquired or constructed with such amounts) are not included in the taxpayer's rate base for rate-making purposes.

(2) EXPENDITURE RULE.—An amount meets the requirements of this paragraph if—

(A) an amount equal to such amount is expended for the acquisition or construction of tangible property described in section 1231(b)—

(i) which was the purpose motivating the contribution, and

(ii) which is used predominantly in the trade or business of furnishing water or sewage disposal services,

(B) the expenditure referred to in subparagraph (A) occurs before the end of the second taxable year after the year in which such amount was received, and

Although the amendment to section 118 specifically directs the Commissioner to issue regulations defining the term "contribution in aid of construction," the Senate Finance Committee Report gave several examples of what the phrase was intended to cover. The Committee Report cited as qualifying examples situations in which a builder or developer constructs water lines, water filtration plants, or water towers and turns them over to a regulated public utility. Similar treatment would be given to payments by builders or developers for such facilities. The report also listed payments by governmental units to regulated public utilities for costs of relocating water or sewer lines occasioned by street repairs as examples of "contributions in aid of construction."[105]

The Conference Report of the Joint Senate House Committee indicates that the amendment to section 118, although directed at Revenue Ruling 75-557, did not entirely overrule it. The revenue ruling specifically dealt with the example of a new home purchaser who was charged a *connection fee* to obtain water service. The connection fee included a construction charge for furnishing and installing a service line and water meter to the water line running to the customer's lot. The Conference Report is careful to distinguish items that will not qualify under the amended section 118 and states that customer connection fees are not qualifying expenditures. The report defines customer connection fees as any amounts paid for the cost of installing the connection between the customer's property and the utility's main water or sewer lines.[106]

(C) accurate records are kept of the amounts contributed and expenditures made on the basis of the project for which the contribution was made and on the basis of the year of contribution or expenditure.

(3) DEFINITIONS.—For purposes of this section—

(A) CONTRIBUTION IN AID OF CONSTRUCTION.—The term "contribution in aid of construction" shall be defined by regulations prescribed by the Secretary; except that such term shall not include amounts paid as customer connection fees (including amounts paid to connect the customer's property to a main water or sewer line and amounts paid as service charges for starting or stopping services).

(B) PREDOMINANTLY.—The term "predominantly" means 80 percent or more.

(C) REGULATED PUBLIC UTILITY.—The term "regulated public utility" has the meaning given such term by section 7701(a) (33); except that such term shall not include any such utility which is not required to provide water or sewerage disposal services to members of the general public in its service area.

(4) DISALLOWANCE OF DEDUCTIONS AND INVESTMENT CREDIT; ADJUSTED BASIS.—Notwithstanding any other provision of this subtitle, no deduction or credit shall be allowed for, or by reason of, the expenditure which constitutes a contribution in aid of construction to which this subsection applies. The adjusted basis of any property acquired with contributions in aid of construction to which this subsection applies shall be zero.

105. S. REP. No. 94-938 Part I, 94th Cong., 2d Sess. 436, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3864.

106. H.R. REP. No. 94-1515, 94th Cong., 2d Sess. 223, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4118, 4205.

The amendment to section 118, then, was not an attempt to overrule Revenue Ruling 75-557, but appeared to be a preemptive strike to prevent more stringent limitations upon the use of section 118 by regulated public utilities. The original Senate Committee Report[107] would have gone even further and directly overriden Revenue Ruling 75-557 because the report claimed the effect of the ruling would be to substantially increase the taxes of utilities and ultimately result in higher charges to customers. The Conference Report of the Joint Senate House Committee, however, elected to sustain the ruling and specifically stated that customer connection fees represented taxable income to the regulated utility.

Although the revenue ruling is broad enough to be applied by analogy to non-water and sewage situations, *e.g.*, electrical services, the amendment to section 118 is specifically limited to water and sewer extension. The ruling does not mention electrical services, but specifically overrules cases in which the service provided was electricity.[108] The apparent reason for the amendment's restriction to water and sewer extensions was fear of lost tax revenue if the amendment had been extended to cover electric utilities.[109]

The tandem effect of Revenue Ruling 75-557 and the amendment to section 118 is to distinguish between contributions for the purpose of connecting a customer to a regulated public utility water or sewer line and contributions for extending the line of the utility to reach the property of the customer. The former is taxable income; the latter is a nontaxable contribution to capital.

The combination of the revenue ruling and the amendment to section 118 is a sound treatment of a regulated public utility that cannot utilize the contribution to capital in its rate-making base. Presumably, a regulated public utility may charge a customer an amount in aid of construction equal to the utility's actual cost of such construction. The contribution by the customer will not increase the utility's profits because the contribution will not be included in the rate-setting base. The effect of the transaction is a mere transfer of title to the assets. No financial or taxable gain or loss is enjoyed or suffered by any of the parties to the transaction. It would be possible for the customers of the utility either individually or collectively to pay the builder or developer for the cost of the extension of water and sewer lines and then to maintain possession of them.

---

107. S. REP. No. 94-938 Part I, 94th Cong., 2d Sess. 434, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3862.

108. Rev. Rul. 75-557, 1975-2 C.B. 33.

109. According to a New York Times article, *supra* note 96, at 15, col. 4, the revenue loss from water and sewer construction being labeled as nontaxable contributions to capital was only $10 million. If telephone and electrical utilities had been included, the annual revenue loss was estimated at $100 million.

The lot owners could also have organized a joint venture and pooled resources to build water and sewer lines to their properties. Such a pooling of resources would not have resulted in taxable income to any of the participants in the joint venture.[110] Taxability should not arise merely because the lot owners, rather than acting as an unincorporated association or partnership, choose to turn over to the utility company the problem of the maintenance, title, and perhaps construction of their water and sewer lines.

The amendment to section 118, therefore, is a rational classification of the contribution of property or money to regulated public utilities. Unlike the case of *Teleservice* such contribution is not payment for services. It is the pure analogy to the contribution by a nonshareholder to the capital stock of a corporation. Thanks to the regulated nature of the utility no abuse of such a system can arise.[111]

In a more sophisticated sense it can be argued that such contributions are similar to those made by the corporate shareholder. In reality every user of a utility's services is in effect a shareholder in that utility. Through his capital contribution to the utility each customer buys a "share" of construction cost of the utility and in turn receives "dividends" in the form of water or sewer service. Recalling that the joint stockholder venture was the forerunner of the corporation, one can see that a regulated public utility is in effect the heir to the historical joint stockholder organization. The regulated public utility also has a relationship to its customers that is very similar to the relationship between a publicly owned corporation and its shareholders. Because the utility must serve all potential customers, it is nonexclusive, except for geographical considerations, just as a publicly owned corporation is nonexclusive with respect to ownership of its stock. The shareholders in a corporation contribute money or property to the corporation in return for dividends or capital gains. A utility customer receives benefits in the form of water or sewer services rather than dividends or capital gains. Just as a shareholder can divest or liquidate his investment by selling his stock, so can a utility customer liquidate his investment by selling the property served by the utility. Regulated public utilities are thus granted treatment parallel to corporations. The amendment to section 118, therefore, may be seen as limiting any possible overreach of Revenue Ruling 75-557.

110. *See generally* Bittker & Rahdert, *The Exemption of Non-Profit Organizations from Federal Income Taxation*, 85 YALE L.J. 299 (1976).

111. Because the utility is regulated it presumedly will not be allowed to charge more for the water or sewer line connection than the extension cost to the utility. A private, nonregulated cable television company is not barred from charging line extension fees that include a profit. Moreover, the cable television company cannot be prevented from including the value of contributed property in calculating the amount of profit necessary to produce a desired rate of return.

V. A Time for Reform

A. *The Lack of a Federal Interest in the Subsidization of Shopping Centers*

Although dealing with customer contributions in the context of a public utility, the 1976 amendment to section 118 failed to address the expanded use of section 118 in the shopping center context. The failure to overrule or circumscribe the holdings in *Federated Department Stores* and *May Department Stores* was unfortunate.[112] The congressional silence can only give encouragement to a wider use of section 118. Since this use can lead to a loss of tax revenue,[113] the federal interest in encouraging a shopping center developer to subsidize a prime tenant must be examined.

The subsidization of a prime tenant by a shopping center developer is an attempt to increase the desirability of a particular location in the eyes of potential tenants and is accomplished in several ways. Assuming that subsidization is made in the form of free land or free building, the prime tenant's initial cost of locating in the shopping center is lower. Thus, a prime tenant who has financial difficulty in acquiring the capital necessary to purchase land or construct a building may only be able to locate in the center if the land or building is provided free. Of course, most prime tenants do not "buy" land or a building; they finance them. The question, therefore, is whether they are financially stable enough or the proposed store is potentially profitable enough to persuade someone to finance the land or the building. The subsidization of the prime tenant enlarges the number of prime tenants who can afford to locate in the shopping center. As a result the developer either escapes complete unavailability of prime tenants or increases the number of potential prime tenants.

Do either of these results benefit the federal government sufficiently to warrant section 118 treatment? Because the only result of the subsidization will be either to make the shopping center a viable project or to increase the project's potential for survival, the answer appears to be no. Additional shopping centers do not produce additional wealth. Presumably if there is X demand or X consumption, that consumption or demand will be met by the existing retail outlets. The addition of one or more shopping centers or the relative economic success of any particular shopping center, as measured by the amount of sales, can have only a marginal impact on the rate of consumption because it is doubtful that additional shopping centers or more suc-

---

112. For a discussion of these cases see section I.F. *supra.*

113. *See* notes 80-85 *supra* and accompanying text.

cessful shopping centers will increase the propensity to consume. It is even more questionable whether shopping center subsidies are the best way to increase consumption if that is desired. It is equally probable that more shopping centers merely switch consumption patterns from existing retail outlets to the new shopping centers. In this manner, the availability of section 118 to developers may even be counter-productive in relation to other professed federal governmental objectives. For example, if it is the goal of the federal government to revitalize the central city and if section 118 encourages the development of shopping centers, which normally are not located in central cities, section 118 contributes to the deterioriation of the central city.[114]

In addition to reducing the initial financing burden on prime tenants, subsidization by the shopping center developer attracts potential retailers by lowering the volume of sales necessary to achieve profitability. A lower sales volume is necessary for three reasons. First, the retailer does not have to earn the profit necessary to pay for the building or land that he uses. Second, the retailer does not have to earn a profit on the investment that he would otherwise have tied up in the building or land. Third, the effect of the tax deferral through the operation of sections 118 and 362(c) increases profits without any corresponding increase in the risk of the project.

Does the federal government have any interest in providing these advantages to certain retailers? It would appear not. The fact that additional retailers are induced to participate in the project is not an occurence of particular concern to the federal government for the reasons listed above. The possibility of increased profitability to a particular retailer, however, is more complicated because the retailer may use the increased profitability in one of two ways. He will either retain the additional profits for his own or his stockholder's benefits, or he will utilize the increased profits to reduce the cost of goods or to increase services to customers and thereby, in part, pass the advantage of the subsidy on to customers of the shopping center. The choice whether to pass any of the savings on to the customer, however, depends solely upon the retailer's perception of which alternative will earn the higher profit for him.

Whether the increased profits go to benefit a corporation or its stockholders or whether the savings are passed on to the customers in the form of lower prices or better services makes no difference to the federal government. Section 118 was certainly not initially enacted to provide a convenient way to aid certain retail groups or their cus-

114. *E.g.*, Demonstration Cities and Metropolitan Development Program, 42 U.S.C. § 3331 (1970).

tomers.[115] Furthermore, the judicial expansion of section 118 to encompass the situations described in *Federated Department Stores* or *May Department Stores* was not anticipated by Congress. The application of the principle that certain transfers from nonstockholders to a corporation should be classified as contributions to capital has come a long way since *Cuba Railroad.*

B. *Possible Congressional Action*

Were it not for the court's holding in *Federated Department Stores*, the logical solution would be to ban the use of section 118 in shopping center situations. Such a limitation, however, would apparently require congressional action because it is doubtful the Internal Revenue Service could accomplish the change through a regulation or revenue ruling. To do so the Service would have to use its administrative authority to overrule or circumvent the courts. Although there is nothing unlawful or ultra vires about the Service's amending its regulations or rulings to place them at odds with court holdings, it nevertheless appears highly unlikely that the Service would do so. Having twice litigated the shopping center subsidization situation and twice lost, the Service is not likely to provide relief in the form of new regulations or rulings, particularly in light of the Service's failure to express a nonacquiesence in either *Federated Department Stores* or *May Department Stores.*

Congress can and should pass appropriate legislation to preclude an unlimited application of section 118. The solution lies in the earlier attempt by the Internal Revenue Service to limit section 118 to contributions by governmental units, civic associations, or the like. Contributions by customers should continue to qualify, but only as they meet the restrictions of section 118(b).

Were such legislation to be passed, the courts could confront the task of identifying "governmental units," "civic associations" or other similar groups. Identification of governmental units should not prove to be difficult. Although the line between public and private agencies is a shadowy one, much light has been thrown upon it as a result of cases involving "state action" concepts under the fourteenth amendment.[116] Identification of civic associations or the like should be greatly aided by section 501 of the Internal Revenue Code.[117] Quali-

115. The legislative history does not indicate any such concern. S. REP. No. 1622, 83d Cong., 2d Sess. 18, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4648; H.R. REP. No. 1337, 83d Cong. 2d Sess. 17, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4025, 4042.

116. *See, e.g.*, Burton v. Wilmington Parking Auth., 365 U.S. 715 (1961); Shelley v. Kraemer, 334 U.S. 1 (1948); Civil Rights Cases, 109 U.S. 3 (1883).

117. I.R.C. § 501(c).

fying groups would be limited to organizations that meet section 501(c) standards, particularly subsections 501(c)(4), (5), and (6).

Because tax revenue lost from the expansion of section 118 into shopping center situations or similar "private contributions" is probably not great at this time congressional reform does not appear likely. Reform did not occur in the 1976 Tax Reform Act, which specifically addressed section 118, and it would be unreasonably sanguine to anticipate further congressional action. If Congress fails to act, however, the expansion and abuse of section 118 can be checked by the courts. A judicial response is particularly appropriate because section 118 is in a very real sense "judicial law." Sections 118 and 362(c) are, after all, congressional attempts to codify the common law of contributions to capital that was originated by the Supreme Court in *Cuba Railroad* and defined and developed by the courts for over twenty years thereafter. Hence, it is in the nature of section 118 that its application be tempered by judicial intervention if that is necessary to avoid perversion of the section's original underlying purposes.

C. *Possible Judicial Action*

Judicial response could come in two ways. First, the courts could overrule the *Federated Department Stores* principle and hold that only governmental units, civic associations, or the like may be the source of contributions to capital without affecting customer contributions sanctioned by section 118(b). In short, the courts could undertake the action suggested for Congress. Were the courts to do so, one could anticipate swift Internal Revenue Service acquiescence. The Service might issue appropriate revenue rulings to clarify limitations on the application of section 118. It is not likely, however, that the courts will specifically limit contributions of capital (other than by customers per section 118(b)) to contributions by governmental units or civic associations. Having failed in its attempt to limit section 118 to contributions by government or civic associations,[118] the Internal Revenue Service cannot reasonably expect to successfully litigate this issue in the future.

As a second judicial response the courts could hold in the appropriate case that although section 118 is not solely limited to contributions by governmental units or civic associations, subsidization activity will be granted section 118 treatment only when the contributor is in fact a governmental unit or a civic association or is a group or individual whose motivations for granting the subsidy parallel those of a governmental unit or civic association. The taxpayer would have the burden of establishing a motivation to benefit individuals, groups, or institutions that a governmental unit or a civic association might

118. Federated Dep't Stores, Inc. v. Commissioner, 426 F.2d 417 (6th Cir. 1970).

reasonably have desired to benefit. In addition, the taxpayer would have the burden of showing that the subsidy recipient would have been the mechanism utilized to achieve the desired benefits.

If an individual or corporation transfers money or property under circumstances that parallel those in which governments or civic groups make transfers, to induce economic activity by the transferee in the form of a locational choice or an enlargement of present facilities, there appears to be no reason not to grant section 118 treatment to such a transfer. The problem is to distinguish that particular sort of transaction from other transfers that an individual or corporation might make. Factually, the problem is not particularly difficult. It should not be difficult for a court to determine whether the sort of transfer being dealt with is comparable to the transfers that were held to be capital contributions in the cases of *Cuba Railroad*, *Brown Shoe*, and their progeny.

Only under circumstances in which the parties are able to show that the transfer might reasonably have been expected to be made by a government or civic group should section 118 status be confirmed. Thus, in the case of *Federated Department Stores* or *May Department Stores* the question would not have been whether the benefit to be realized by the transferor was direct or indirect, or what the motivation of the transferor was, but rather whether a government or civic group could have been expected to subsidize a department store in the same or similar manner.

Answering the question whether a governmental unit might have been the origin of the questioned subsidy is not as difficult as it might first appear. First, it should be recognized that the great majority of governmental subsidization of private activity does not take place in the form of outright grants of money or property to the recipient corporation. In most cases governmental subsidization occurs in the form of lowered taxes or the use of governmental borrowing authority to allow the recipient to take advantage of lower interest rates. Another common subsidization device is construction of the requisite facility by the government and rental to the recipient corporation at a reduced rate or a rate reflecting the lower costs of construction incurred by the government because of its avoidance of local taxes and lower interest rate on borrowings. Of course, local governments may undertake more direct subsidization such as agreements to reimburse employers who maintain certain members or employees on the payroll in the event that the profitability of the enterprise does not meet certain prearranged standards. This type of subsidization is distinguishable from an outright grant of a fee interest in the building or of the unqualified use of property or cash.

Distinguishing legitimate subsidization projects of a civic association is more difficult. A civic association by its nature will subsidize at those points where it is incapable of persuading the local government to subsidize or because the form of the subsidy offered by the local government is either unacceptable or insufficient for the recipient corporation. Thus, one can expect a wider variety of subsidization forms—often more generous or more direct—by local civic associations. The line between what a civic association might do and what a private developer might undertake can nevertheless be drawn. Perhaps the underlying test is whether the economic activity to be undertaken by the subsidy recipient can reasonably be expected to produce benefits for the members of the civic association. The classic cases of subsidization in this area occur when a civic association subsidizes a major manufacturing firm's entrance into the area. The resulting increase in employment and the general spur to the local economy is a benefit to the members of the civic association. Certainly the influx of a major employer can be distinguished from a new retailer who cannot produce additional production in the area. At best the establishment of a new retailer results in the movement of economic activity from a neighboring retailing center. It is possible that the suburban civic association might subsidize a shopping center in order to take over the economic retailing activity that takes place in the central city or shopping centers in neighboring communities.

The burden should be upon the taxpayer to prove that subsidization might reasonably have been undertaken by some level of government or a local civic association. Such a requirement would be in line with the normal burden of proof carried by the taxpayer. Any corporation receiving a contribution to capital from anyone other than a governmental unit or civic association would be taxed on such contribution unless the recipient corporation overcame the presumption of taxability. What elements, then, must the corporation prove in order to rebut the presumption of taxability? Stated another way, what should be the elements that distinguish nontaxable contributions by governments or civic associations from taxable contributions by private individuals, corporations, or other entities?

Historically, contributions to capital were motivated by a desire to benefit two distinct groups. From the days of *Liberty Light* to the present—as seen in the recent amendment to section 118—contributions to capital have included situations in which a utility customer turned the asset, or an amount equal to its cost, over to the utility rather than retaining ownership of the utility line extension. The other category of beneficiaries traces its origins from *Cuba Railroad.* In that case and its progeny, many if not all of those benefiting did not directly participate in the contribution. The contributor, whether a government or a civic association, although interested in benefiting itself to a greater or lesser degree, was nevertheless motivated or was at least aware of the potential benefits accruing to its community residents.

In other words, the contributor might have been primarily interested in its own benefit, but was also motivated by the presence of direct or indirect benefits, whether primary or spin-off, to other noncontributory elements.

The success of a new shopping center might bring significant benefits to neighboring land owners in the form of rising land values. Nearby businesses may profit handsomely from the opening of a shopping center. Employment opportunities may be enhanced for local residents. Increased tax revenues may benefit the local taxing authority, as well as the local taxpayers. However, indirect or spin-off benefits such as these are similar to those resulting from subsidization by a civic association. All the benefits listed above would, for example, be present in the event that a civic association subsidized the location of a new manufacturing plant. Nor can one distinguish the civic association from the private contributor on the basis that benefits are being enjoyed by the contributing party. The shopping center developer seeks a quid pro quo when he subsidizes a tenant. Similarly, the individual members who make up the civic association are likely to anticipate individual economic benefits as a result of the subsidization activities of the association. Consequently, examining only the benefits arising from subsidization will not greatly aid the courts in establishing a standard that will allow them to differentiate between civic associations and nonqualifying shopping center developers.

The solution is to look not merely at the character of the recipient of the benefits or at whether the benefits realized by the subsidizing party are direct or indirect, but at the *value* of the totality of benefits accruing to the subsidizing party. If the value of the benefits is relatively equal to the cost of subsidy, the transfer should be classified as income to the recipient corporation. It is unusual, but fair, that the taxable consequences to the recipient corporation depend upon the degree of benefit enjoyed by the transferor because the essential test, as first enunciated in *Cuba Railroad*, is whether the transfer represents payment for services. Today that test is still actively applied, but the courts have mistakenly focused on whether the benefits are direct or indirect.

The distinction between direct and indirect benefits is unsound. The courts that applied that distinction should have been concentrating on whether "services" were being rendered. Had they done so, the courts might have come to the realization that "services" can be "rendered" in ways far more esoteric than those imagined by the Supreme Court in *Cuba Railroad*. Services can be rendered by the sale of the products of the transferor. They can also be "rendered" by a recipient corporation even though it takes no active steps to aid or benefit the transferor.

The clearest example of rendering services occurs when there is an actual exchange of services, for example, supplying cable television programs in exchange for the line extension.[119] A less obvious example of rendering services occurs when the subsidy recipient undertakes activity that directly promotes both his own well-being and the well-being of the transferor, for example, when a car dealer in exchange for a cash subsidy agrees to relocate and sell the products of the subsidizing party.[120] The recipient renders the service, the sale of the product, while equally, if not even more so, serving his own interests.

In the context of a shopping center development the recipient may render valuable service to the transferor even though their relationship is landlord and tenant, or seller and purchaser of land. The anchor store in the shopping center renders an ascertainable and valuable service to the shopping center developer even though the store does nothing but pursue its own economic interest. The shopping center developer who grants free land or a free building to an anchor store is "buying" the economic advantage to be gained as much as if he had purchased the right to receive cable television by agreeing to subsidize the cost of the extension of the cable line. If the transferor can reasonably expect to receive economic benefits roughly equal to the cost of the subsidy, the transfer represents payment for those benefits, or "rendered services." The recipient corporation has thereby "sold" something of value even if the benefit sold is a noncontrollable, nondirectable, spin-off from its economic activity. The fact that the locational decision of a retail store has become a commodity that can be "sold" to a shopping center developer represents a new, albeit unusual and unexpected, source of income to the recipient store. Were the courts to perceive these so-called contributions to capital by individuals or entities other than governments or civic associations as the disguised purchases that they are, the courts would have little hesitancy in supporting the Internal Revenue Service in its efforts to tax the transfers.

VI. CONCLUSION

As has often been said, that which can be done will be done. With the propensity of taxpayers to avoid taxes whenever possible, if a standard or attempt to restrict the limits of section 118 is not forthcoming, it seems only a matter of time until more and more taxpayers become cognizant of the potential advantage inherent in the liberal application of section 118. Such expansion of section 118 is not by itself a major problem when compared with the other revenue

119. Teleservice Co. v. Commissioner, 254 F.2d 105 (3d Cir.), *cert. denied*, 357 U.S. 919 (1958).

120. John B. White, Inc. v. Commissioner, 55 T.C. 729 (1971), *aff'd*, 458 F.2d 989 (3d Cir. 1972).

losses inherent in the Internal Revenue Code. Nevertheless, it appears to be a particularly unnecessary one. If Congress cannot be made to take an active role to limit the possible expansion of section 118, it is up to the courts and the Internal Revenue Service to formulate standards that will carry out the intent of Congress under section 118, denying its protective cover from situations never contemplated by the Congress and not warranting the advantages of section 118.